INTERNAL CONTROLS : An Introduction

State of Arizona

General Accounting Office

Background

- The State of Arizona continues to undergo significant budgetary pressures among other changes. Changes in environment can significantly impact internal controls. The General Accounting Office is providing policies and procedures to assess and mitigate risk in the State.
- As public sector managers and employees we are accountable for the resources entrusted to us and for ensuring our programs and services are administered effectively and efficiently.
- A significant component in fulfilling this responsibility is ensuring that an adequate system of internal control exists within each State government entity.

The COSO* Definition of Internal Control

Internal control is ***a process***, effected by an entity's board of directors, management, and other personnel, ***designed to provide reasonable assurance*** regarding the achievement of objectives ***in the following categories:***

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

* Committee of Sponsoring Organizations of the Treadway Commission

Simple Definition

- Internal control is what we do to see that the things we want to happen **will** happen ...

- And the things we don't want to happen **won't** happen.

Internal Controls Are C*ommon Sense*

What do you worry about going wrong?

What steps have been taken to assure it doesn’t?

How do you know things are under control?

You exercise internal control principles in your personal life when you:

- Lock-up valuable belongings
- Keep copies of your tax returns
- Balance your checkbook
- Keep your ATM/debit card PIN number separate from your card

Why are Internal Controls Important?

- Compliance with applicable laws and regulations.
- Accomplishment of the entity's mission.
- Relevant and reliable financial reporting.
- Effective and efficient operations.
- Safeguarding of assets.

Weak Internal Controls

Increase Risk Through…

- Business Interruption

  system breakdowns or catastrophes, excessive re-work to correct for errors.

- Erroneous Management Decisions

  based on erroneous, inadequate or misleading information.

- Fraud, Embezzlement and Theft

  by management, employees, customers, vendors, or the public-at-large.

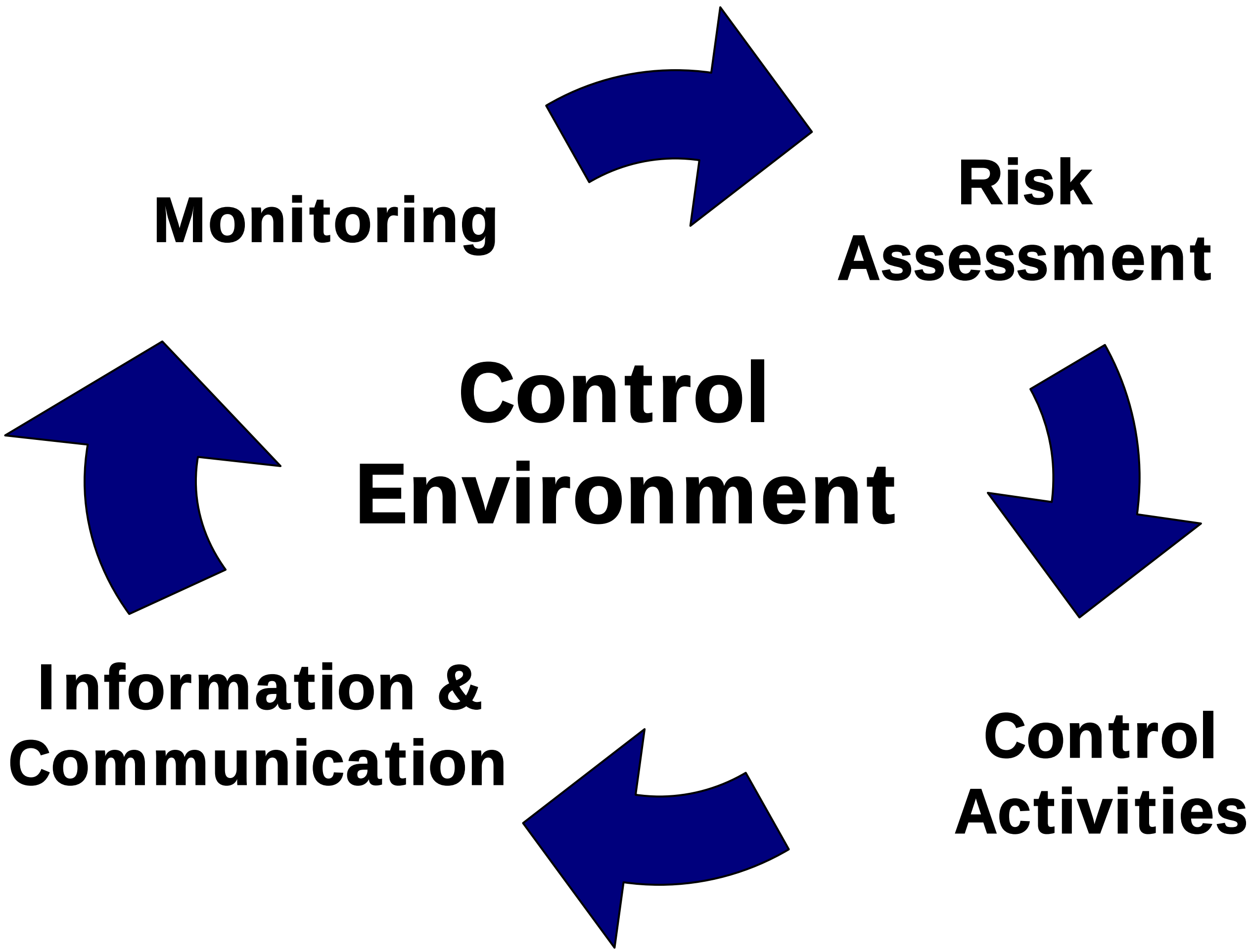
- <u>Statutory Sanctions</u>

  penalties arising from failure to comply with regulatory requirements, as well as overt violations.

- <u>Excessive Costs/Deficient Revenues</u>
  expenses which could have been avoided, as well as loss of revenues to which the organization is entitled.

- <u>Loss, Misuse or Destruction of Assets</u>
  unintentional loss of physical assets such as cash, inventory, and equipment.

COSO'S Internal Control Framework… Five Inter-Related Standards:



1. Control Environment

- Foundation for all other standards of internal control.
- Pervasive influence on all the decisions and activities of an organization.
- Effective organizations set a positive "**tone at the top**".
- Factors include the integrity, ethical values and competence of employees, and management's philosophy & operating style.

2. Risk Assessment

- Risks are internal & external events (economic conditions, staffing changes, new systems, regulatory changes, natural disasters, etc.) that threaten the accomplishment of objectives.
- Risk assessment is the process of identifying, evaluating, and deciding how to manage these events... *What is the likelihood of the event occurring? What would be the impact if it were to occur? What can we do to prevent or reduce the risk?*
- *Internal Controls are likely to be inadequate or inefficient without proper understanding of risk.*

3. Control Activities

- Tools encompass policies, procedures, and processes designed and implemented to help ensure that management directives are carried out.
- Help prevent or reduce the risks that can impede the accomplishment of objectives.
- Occur throughout the organization, at all levels, and in all functions.
- Include approvals, authorizations, verifications, reconciliations, security of assets, reviews of operating performance, and segregation of duties.

4. Communication & Information

- Pertinent information must be captured, identified and communicated on a timely basis.
- Effective information and communication systems enable the organization's people to exchange the information needed to conduct, manage, and control its operations.

5. Monitoring

- Internal control systems must be monitored to assess their effectiveness... *Are they operating as intended?*
- Ongoing monitoring is necessary to react dynamically to changing conditions...*Have controls become outdated, redundant, or obsolete?*
- Monitoring occurs in the course of everyday operations, it includes regular management & supervisory activities and other actions personnel take in performing their duties.

Your Organization Benefits from Strong Internal Controls by:

- Reducing and preventing errors in a cost-effective manner.
- Ensuring priority issues are identified and addressed.
- Protecting employees & resources.
- Providing appropriate checks and balances.
- Having more efficient audits, resulting in shorter timelines, less testing, and fewer demands on staff.

Proper Internal Controls...

- Effectively mitigate risk when taken as a whole.
- Make sense within each organization's unique operating environment.
- Benefit rather than encumber management.
- Are not stand-alone practices; they are woven into day-to-day responsibilities.
- Consider relative cost and benefit.
- Are designed to be as efficient as possible.

Important Concepts...

- Internal control is a process; it is a means to an end, not an end itself.
- Internal control is effected by people; it's not merely policy manuals and forms but also people at every level of an organization. Failure to perform the control does not mitigate risk and wastes resources.
- Internal control can be expected to only provide <u>reasonable assurance</u>, not absolute assurance.

The Internal Control Self-Assessment consists of the following sections and accounting cycles:

- Control Environment
- Risk Assessment
- Financial Reporting Cycle
- Budget Reporting Cycle
- Cash Receipts Cycle
- Accounts Receivable Cycle
- Purchasing/Accounts Payable Cycle
- Inventory Cycle
- Fixed Assets Cycle
- Investment Cycle
- Payroll Cycle
- Debt Cycle

The goal of these sections is to effectively and efficiently help to mitigate risk.

Five Key Internal Control Activities...

1. Separation of Duties

- Divide responsibilities between different employees so one individual doesn’t control all aspects of a transaction.
- Reduce the opportunity for an employee to commit and conceal errors (intentional or unintentional) or perpetrate fraud.

2. Documentation

Document & preserve evidence to substantiate:

- Critical decisions and significant events…typically involving the use, commitment, or transfer of resources.
- Transactions...enables a transaction to be traced from its inception to completion.
- Policies & Procedures...documents which set forth the fundamental principles and methods that employees rely on to do their jobs.

3. Authorization & Approvals

- Management documents and communicates which activities require approval, and by whom, based on the level of risk to the organization.

- Ensure that transactions are approved and executed only by employees acting within the scope of their authority granted by management.

- Authorization should be adequate but not excessive.

4. Security of Assets

- Secure and restrict access to equipment, cash, inventory, confidential information, etc. to reduce the risk of loss or unauthorized use.
- Perform periodic physical inventories to verify existence, quantities, location, condition, and utilization.
- Base the level of security on the vulnerability of items being secured, the likelihood of loss, and the potential impact should a loss occur.

5. Reconciliation & Review

- Examine transactions, information, and events to verify accuracy, completeness, appropriateness, and compliance.
- Base level of review on materiality, risk, and overall importance to organization’s objectives.
- Ensure frequency is adequate enough to detect and act upon questionable activities in a timely manner.

Wrap Up

Effective Internal Controls:

- Help rather than act as barriers.
- Make sense within each organization’s unique operating environment.
- Day to day responsibilities of managers and staff are not stand-alone practices.
- Cost effective which saves time & money